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Alert: Is an Act 60 Taxpayer Required to Have a Transfer Pricing Study?

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No. The IRS does not require any taxpayer to develop a transfer pricing study. The real question is "what would a transfer pricing study do for me?" The answer is that a properly-crafted study: (1) will provide you with a better understanding of the transfer pricing risk that you face on your filed U.S. tax returns; (2) allow you to avoid mispricing on your next U.S. tax return; and (3) protect your next return from penalties that can be as high as 40% of the additional taxes due, if the IRS adjusts your transfer pricing. In short, a transfer pricing study brings discipline to your pricing and to your tax reporting. [1]

Why Should You Care about Transfer Pricing?

On January 29, 2021, the IRS added a new audit campaign named "Puerto Rico Act 22, Individual Investors Act" with three primary areas of focus:

- Identifying individuals who have Act 22 decrees but that do not satisfy the IRS requirements for excluding income or being treated as bona fide residents of Puerto Rico;
- Determining if individuals are inappropriately claiming non-Puerto Rico-sourced income as Puerto Rico-sourced income in order to avoid U.S. tax; and
- Addressing areas of non-compliance through examinations, outreach, and soft letters.

Almost every Act 22 situation involves some transfer pricing risk. We believe that Act 20 entities also will become targets of the campaign; and we have yet to see an Act 20 situation that does not involve some transfer pricing.

In short, you need to care about transfer pricing because the IRS is going to be looking at your transfer pricing if they audit you.

What is Transfer Pricing?

Transfer pricing is the IRS (and global) requirement that "controlled parties" must price transactions at "arm's length."

Controlled Parties – If two different companies, partnerships, individuals, trusts, S corporations, etc. are commonly controlled, then transfer pricing rules apply. IRS regulations define common control very broadly:

> Controlled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

[1] Thanks to Tom Duffy of Tom Duffy CPAs, who provide helpful input to this article.

The normal and obvious case of common control is when a taxpayer personally owns both a US corporation and a Puerto Rican corporation. The corporations are commonly controlled through common ownership.

But unrelated parties – you and your client, you and a contractor, two corporations owned by different individuals, etc. – could be treated as commonly controlled if they are "acting in concert" to shift income or avoid tax. For example, if a U.S. client pays a royalty of $10 to your Act 20 company and pays $990 of services fees, the IRS could adjust both prices to $500 (because royalties paid by a US taxpayer to a Puerto Rican company are subject to 30% U.S. withholding tax, while services payments are not).

Arm's Length Pricing – Transfer pricing between controlled parties must be conducted at "arm's length." The arm's length price is the price at which third parties – who naturally deal at arm's length – would be willing to transact.

The arm's length pricing requirement applies to all controlled transactions. These are most commonly service transactions, but can also be the sale of physical goods between parties, the license of software or brands, loans, insurance payments, leases, purchases of capital assets, etc. Any transaction that can be conducted between two taxpayers can be subject to the arm's length standard.

How Do You Show that You've Met the Arm's Length Standard?

Every situation is different, and IRS regulations provide various methods to establish that transfer pricing was done at arm's length. But almost all transfer pricing analyses involve two things: (1) the identification of comparable transactions or comparable parties that look like the controlled transaction or controlled party; and (2) the creation of a range – the "arm's length range" – of permissible pricing outcomes.

A quick example – a Puerto Rican LLC provides services to its related party and, as compensation, receives 15% of the revenue generated by the related party. If PR LLC also has transactions with 20 different third parties, and in each of those transactions it receives between 8% and 10% of revenues generated by the third party, the IRS likely would conclude that the transfer pricing is not arm's length and that PR LLC is earning too much income. Had the third parties instead paid between 14% and 18% of revenues, the 15% likely would be considered arm's length.

A lot of this is common sense, but it helps to know the rules and how to identify and use comparables. What's most important is to perform the analysis.

When Does It Make Sense to Develop a Transfer Pricing Study?

The act of analyzing your transfer pricing is the first step in developing a study. Once you've decided on an approach, the study is simply documenting that analysis in a manner that meets the IRS transfer pricing "documentation" rules. In other words, once you've taken the time to evaluate your transfer pricing, it will typically be cost effective to prepare a study.

For taxpayers with complex pricing issues, a study typically makes sense. Complex issue can include the presence of valuable intangibles in a business, the use of a profit split to determine pricing, the payment of all residual profit, or all profits above what would be considered a "normal amount" to only one party, and in other situations that are either difficult to understand or have large profits.

How Does the Transfer Pricing Documentation Fit with Other Best Practices?

Any Act 22/20/60 grantee who transacts with controlled parties in the U.S. should consider the following best practices to protect against transfer pricing adjustments and penalties:

1. Establish arm's length transfer pricing policies from the start. After determining whether controlled transactions exist, work with an advisor to determine the most appropriate way they should be priced.

2. Before closing the books for the year or filing a tax return, ensure that the actual results are in line with what was intended. Ideally, this should happen at least once during the year as well so that large adjustments are not needed at year end.

3. Prepare transfer pricing documentation, demonstrating that the transfer pricing on related party transactions is arm's length. To protect the company from penalties, a transfer pricing report must be completed by the time the tax return for the year is filed. Without documentation, the IRS could also impose penalties equal to 20% or 40% of the incremental tax from IRS adjustments to your transfer pricing.

4. If your company has transfer pricing exposure on previously-filed returns, it may be worth determining whether retrospective transfer pricing exposure exists. Preparing a transfer pricing report to support back years may also be helpful in evaluating and thereby mitigating prior year risk.

There are many other nuances to transfer pricing that fall within (and outside) the above points. Every company has different facts and circumstances that must be evaluated independently. There is no "one size fits all" approach. Taking the time and effort to be proactive in setting and documenting arm's length transfer pricing will likely pay off in the long run as the IRS continues its Puerto Rico Act 22 campaign.

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The Valentiam Group is made up of industry-leading professionals who have worked together for many years. The core of the group has been together for 10 years, and some of our partners have worked together for over two decades.

The name Valentiam is new, because we've formed a single group of extraordinarily credentialed experts who wish to brand ourselves as one of cohesive group. The company is named after the Latin phrase *ad valentiam*, "to the value," to indicate the trusted accuracy of the work we do. Our Partners, Directors, Senior Staff, and other professionals have been formed from legacy Big 4 accounting firms and other respected boutique firms specializing in Transfer Pricing and Valuation.

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